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FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of)
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Petition of LCI Telecom Corp.)
for Declaratory Rulings)
_____)

CC Docket No. 98-5

COMMENTS OF THE
COMPETITION POLICY INSTITUTE

Ronald Binz, President and Policy Director
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Summary of the Comments of the Competition Policy Institute

LCI has offered a unique and thoughtful proposal to speed the introduction of local exchange competition and to increase the chances that a regional Bell Operating company will be allowed into the long distance market. In particular, LCI accurately recognizes that the local exchange carrier operations of the RBOCs do not have sufficient incentives to open their networks to competition on a nondiscriminatory basis. LCI attempts to address these incentives by proposing to separate the wholesale and retail operations of the RBOC into separate subsidiaries with a variety of safeguards designed to protect against favoritism and cross-subsidization.

The LCI proposal has several meritorious features but falls short of solving the problems that it identifies. Under LCI's proposal, the facilities-owner (NetCo) would continue to have incentives to favor its retail affiliate (ServeCo) over unaffiliated CLECs. Furthermore, the proposal to modify the incentives under Section 271 could potentially allow the RBOCs to enter the long distance market without having "fully implemented" the competitive checklist. Failure to implement the competitive checklist could substantially delay local competition even more than the delays that have occurred so far. Finally, it is unclear whether the FCC has the legal authority to alter the requirements of section 271. LCI proposes that, once the RBOC has separated its wholesale and retail operations, the burden of proof would lie with competitors to prove that the RBOC has not satisfied the preconditions for long distance entry. Section 271, however, appears to place this burden on the RBOC.

Nevertheless, the shortcomings of the LCI proposal could be cured taking LCI's basic idea a few steps further. CPI suggests the following amendments to the LCI proposal:

- Rather than allow joint ownership of NetCo and ServeCo, as LCI proposes, NetCo or ServeCo should be spun off. This would separate the owner of the bottleneck facilities from the retail operations completely. In the alternative, the LCI proposal could be modified by requiring that NetCo, not ServeCo, be subject to the safeguards (40% outside ownership, independent directors, etc.) that LCI proposes for ServeCo.
- As for the FCC's legal authority to require these conditions before Section 271 relief is granted, these reforms can best be considered under the "public interest" prong of the three-part entry test, or separately from Section 271 altogether. If the FCC finds that the RBOC has established the structural separation proposed in these comments, the FCC could take account of this fact in determining whether the RBOC meets the "public interest" test. Alternatively, the RBOC's retail affiliate, if separated from the wholesale network owner, could be eligible for treatment as a non-dominant carrier.

Comments of the Competition Policy Institute

The Competition Policy Institute (CPI) respectfully submits these comments on the Petition of LCI International Telecom Corp. for Expedited Declaratory Rulings. CPI is an independent, non-profit organization that advocates state and federal policies to promote competition in telecommunications and energy services in ways that benefit consumers.

In its Petition for Declaratory Rulings ("Petition"), LCI submits a proposal designed to "jump-start" competition and "break the logjam" to bring the benefits of competition to residential consumers. LCI's proposal asks the Federal Communications Commission ("FCC" or "Commission") to adopt a new interpretation of section 271 that will encourage the Regional Bell Operating Companies (RBOCs) to voluntarily restructure themselves to separate their wholesale and retail operations.

LCI's Petition offers a thoughtful analysis of why local telephone competition has not developed as rapidly as many had hoped. By focusing on the RBOCs' incentives to open up their local network, LCI attempts to address the root of the problem, rather than the details of implementation. At a minimum, LCI's proposed solution, by encouraging but not mandating separation of the network provider from the retail provider, is creative and deserves close scrutiny by the Commission.

LCI's Petition raises some of the most fundamental questions in telecommunications policy: to what extent are the barriers to local competition related to actions or inactions of the RBOCs? To what extent are the RBOCs' actions the result of distorted incentives? To what extent are the difficulties of local competition development simply the result of technical and transitional delays? Was Congress wrong in its theory that the prospect of long distance entry

would be a sufficient incentive for the RBOCs to open their networks? What effect would a wholesale/retail restructuring have on local telephone rates? On universal service subsidies? On the deployment of advanced technologies?

For these reasons, the FCC should consider the LCI Petition as the beginning of a new round of debate over RBOC structural issues on a national level. While two states, New York and Connecticut, have experimented with voluntary restructuring of telephone companies, neither Congress nor the FCC has considered this question directly until now. Rather than endorse or oppose the LCI proposal, our comments will focus on the issues raised by LCI and offer some alternatives for the FCC's consideration.

CPI urges the Commission to examine these issues closely before adopting any particular approach. For these reasons, we suggest that the Commission initiate an investigation into the issues raised by the LCI Petition. A simple notice and comment process is not likely to provide sufficient record evidence on which the Commission can base a decision on these issues. Commission staff (in particular, the Commission's Local Competition Task Force) could be assigned to gather evidence and review the proceedings in other states, investigate the grounds for the proposed relief, and analyze the legal arguments in detail.

A. The LCI Petition Is One of Several Proposals the Commission Should Consider to Promote Local Competition.

The concerns raised by LCI must be placed in a larger context. The distorted incentives of the RBOCs to open their markets to competition is one of several factors that inhibit the growth of local telephone competition. For instance, even if the RBOCs had every conceivable incentive to open their networks, doing so is still not easy. Local exchange networks were built

in a monopoly environment; re-engineering those networks to accommodate multiple providers of local services, with unique demands and differing interconnection requirements, is inherently difficult.

Further, other factors affect the pace of local telephone competition in addition to the action or inaction of the RBOCs:

- a) municipal control over rights-of-way;
- b) landlord control of access to their buildings and tenants;
- c) the inherent costs and time involved in constructing competing networks; and
- d) resolution of number portability issues.

These and other issues were brought to the Commission's attention when it requested comments on Commission actions critical to the promotion of efficient local exchange competition.¹

Thus, we doubt that simply altering the incentives of the RBOCs will "break the logjam and jump-start more active retail . . . competition." (Petition, p.3) Improving the RBOCs' incentives will surely make it easier for local competitors to obtain the cooperation of the RBOCs. But the Commission should not repeat the mistakes of the policymakers who predicted that local telephone competition would arise immediately after passage of the Telecommunications Act of 1996. The Commission should not trust any particular solution to "solve" the local competition problem, for many factors affect the growth of this market in addition to the incentives of the RBOCs.

¹ Common Carrier Bureau Seeks Recommendations on Commission Actions Critical to the Promotion of Efficient Local Exchange Competition, CCB Pol 97-9, DA 97-1519, released July 18, 1997.

On the other hand, it is increasingly clear that the Commission must take action on a number of fronts to stimulate competition in the local market. After asking for comments last year and forming a local competition task force, the Commission has taken little action to accelerate the growth of local competition. In fact, the Commission has recently indicated an interest in speeding up the process by which the RBOCs receive long distance approval, arguably dampening the RBOCs' incentives to open their markets any faster.

Thus, the LCI petition should be considered in the context of several issues that the FCC can and should take to stimulate local telephone competition, including stronger enforcement against barriers to entry under section 253, adoption of a competitively neutral universal service plan, sanctions against carriers for failing to open their networks, and efforts to require building owners to provide access to competitive local exchange carriers.

B. The RBOCs' Incentives.

The LCI Petition identifies three "critical barriers" to local telephone competition -- OSS, provision of the UNE Platform, and pricing. LCI asserts that the RBOCs' conflicting roles as both wholesale operator of a facilities network and retail competitor distorts their incentives to comply with the FCC requirements and remove these barriers. The Petition then discusses LCI's proposed solution -- separating the wholesale and retail operations of the RBOCs.

Before considering the solution, it is worthwhile to consider the nature of the three problems identified by LCI in more detail. The following analysis asks the direct question -- does the problem exist because of the RBOCs' incentives or are there other reasons for the difficulty?

The OSS barrier: There are many causes of the OSS problems, including some

RBOCs' unwillingness to provide others with the same quality of access, the difficulty of establishing different OSS interfaces for different competitors, and the competitors' own difficulty in setting up their OSS interfaces and training the staff to submit accurate information. While competitors have every incentive to remedy their OSS problems, the RBOCs have no such incentive. The RBOCs' retail operations already receive the equivalent of high-quality OSS access from their network operators. Developing sophisticated and nondiscriminatory OSS benefits only their competitors. The technical difficulties of providing nondiscriminatory OSS, and the competitors' own OSS problems, are likely to diminish over time. The RBOCs' incentives to provide nondiscriminatory OSS, however, will likely persist as long as the RBOC is both a wholesale and retail provider. In short, LCI is correct about the effect of the structural arrangements on incentives to provide nondiscriminatory OSS.

The UNE Barrier: LCI complains not that the RBOCs have failed to provide UNEs, but that they have failed to provide them "in the manner requested by the CLECs" (Petition, p.7). In particular, LCI expresses its frustration about the RBOCs' response to requests for network platform configurations. This problem is clearly one of incentives. The RBOCs already provide these packages of elements to themselves, so there is little technical reason they cannot provide the same package to competitors if they have the right incentives. Yet an RBOC currently has little incentive to provide a "platform" of bundled UNEs for companies that are seeking to compete with its retail operations. This is especially true because the prices for UNEs (whether offered individually or in a platform) are, in most cases, significantly less than the prices the RBOC is allowed to charge for retail services. The RBOCs lost the challenge to the FCC's unbundling requirements before the Eighth Circuit Court of Appeals. But the RBOCs won the

right not to have to provide the platform to competitors (the “rebundling” issue). Since this decision, to CPI’s knowledge, no RBOC has voluntarily “rebundled” the UNEs together into a “platform” for competitors, unless the competitor pays a significant “glue” charge.

The Pricing Barrier: LCI voices two problems with the pricing of UNEs — the level of prices and the potential for discrimination. LCI maintains that cost-based rates are “critical” to permit competition and to promote efficiency. LCI also states that “competition will be impossible if RBOCs are able to charge their retail competitors higher rates for wholesale inputs than the internal cost reflected in the RBOCs’ own retail operations.” (Petition, p. 10)

The RBOC’s “conflicting roles” as a wholesale and retail provider would appear to affect their incentives to engage in price discrimination. This price discrimination issue would appear to be related to the network provider’s affiliation with the retail arm. If a holding company owns the network and the retail provider, it would prefer that the retail arm receive lower prices for access to the network than unaffiliated retailers.

However, it does not appear that the structural arrangement affects the incentive to price UNEs at LCI’s desired level. Whether or not the RBOC network supplier is affiliated with a retail provider, the network provider will engage in profit maximizing behavior. Since there are virtually no competing providers of facilities in any RBOC’s region, the network supplier is likely to seek rates that are as high as regulators will allow.

In sum, CPI agrees that most of the issues raised by LCI are related to the joint ownership of the network and the retail operator. The RBOCs have distorted incentives to favor their retail operations in the provision of OSS, the UNE platform, and price. Only LCI’s concern about cost-based rates appears not to be related to the RBOCs’ conflicting roles as network supplier

and retail provider.

C. LCI's Proposed Solution

To address its concerns, LCI proposes that the RBOCs “would separate completely their retail and wholesale activities.” (Petition, p. 14) Unfortunately, LCI’s proposal does not propose complete separation of the ownership of these functions. Instead, LCI proposes that the RBOC holding company (“HoldCo”) would continue to own the network provider (“NetCo”) and 60% of the retail provider (“ServeCo”). In CPI’s view, the continued affiliation of NetCo and ServeCo will not solve the incentive problem that LCI identifies. As long as NetCo and ServeCo are jointly owned, the RBOC’s HoldCo will prefer to give its retail arm favorable access to the network.

LCI proposes a number of measures designed to enhance the separation between the two entities. ServeCo and NetCo would not share officers, directors, or assets; ServeCo would have 40% outside ownership; ServeCo would have independent board members; compensation of ServeCo management would be tied only to the financial success of ServeCo, etc. NetCo would not be permitted to engage in retail marketing and would only be allowed to provide retail service to its existing consumers on a transitional basis.

These measures do not appear to be sufficient to overcome the incentives of NetCo to give ServeCo preferential treatment. The safeguards might improve the situation, but are not sufficient to negate the company’s profit maximizing incentives. For instance, the requirement that ServeCo maintain 40% outside ownership, separate employees, officers, directors, and compensation from NetCo and HoldCo may help to increase the reporting requirements under the securities laws. But these separation requirements do little to dampen the incentives of

NetCo to favor ServeCo since HoldCo owns NetCo and 60% of ServeCo's stock. Clearly, HoldCo will continue to have incentives to favor ServeCo as long as HoldCo retains 60% of ServeCo's profits. ServeCo is unlikely to refuse to accept the favorable treatment since its outside owners and directors will profit just as much from NetCo's favorable treatment as will HoldCo's shareowners.² Under LCI's proposal NetCo's incentives to favor its affiliate will be diminished slightly because HoldCo will only earn 60% of the excessive profits rather than 100% as is the case today.³

We conclude that the incentives of the facilities provider can only be changed by separating the ownership as well as the operation of the wholesale and retail arms. There are two ways to accomplish this. First, HoldCo could divest itself of its retail services altogether. HoldCo would retain ownership of NetCo and could also own other subsidiaries or affiliates that provide non-telecommunications services and telecommunications services outside of the region where NetCo was the dominant provider of local exchange facilities. HoldCo would, however, be prohibited from providing retail telecommunications services where it provides dominant local telephone service.

² LCI suggests that outside ownership of ServeCo would increase accountability because ServeCo "would be subject to suits from its public shareholders if operated in a way that unduly advantages HoldCo (or any of HoldCo's affiliates, including NetCo)." (Petition p. 17) This concern appears to arise from the potential transfer of assets between NetCo and ServeCo that may result in cross-subsidization. LCI, however, proposes that any transfer of assets between the two companies be quite limited. (Petition, note 25) Further, the principal concerns that LCI raises revolve around discrimination, not cross-subsidization. Thus, even if the 40% outside ownership limits the potential for cross-subsidization, it does not limit the more significant problem of discrimination.

³ LCI does not appear to allow some common ownership in order to promote any efficiencies because LCI proposes that NetCo treat ServeCo like any other retail provider.

Second, HoldCo could divest itself of the local telephone network altogether. In this scenario, HoldCo would retain ownership of the retail services arm and all its other telecommunications businesses. NetCo would be the sole owner of the network facilities and would be limited to providing access to its network on a wholesale basis under many of the same terms that LCI has already identified in its proposal.⁴ Since either of these approaches would remove the incentives of NetCo to favor a particular retailer, the RBOC could be permitted to choose the mode of divestiture.

A different, less radical modification to the LCI proposal would be to require that NetCo, not ServeCo, be subject to the safeguards (40% outside ownership, independent directors, etc.) that LCI proposes for ServeCo. Presumably the outside directors of NetCo would have greater concerns about providing discriminatory treatment to ServeCo, a company in which they have no interest. These directors would have a fiduciary and legal obligation to oversee NetCo's operations to ensure that NetCo obeys the law and complies with the FCC's requirements.

Either scenario would substantially improve the likelihood that the RBOC would provision OSS and the UNE platform to competitors in a nondiscriminatory fashion, and that the

⁴ This proposal would have some similarity to the "LoopCo" proposals referenced in the LCI Petition and submitted to the FCC by Roy Morris. See Comments of USOne, August 11, 1997, in response to the Common Carrier Bureau's Request for Recommendations on Commission Actions Critical to the Promotion of Efficient Local Exchange Competition, CCB Pol 97-9, DA 97-1519, released July 18, 1997. The difference would be that, rather than separate only the loop functions of the telephone company network, as proposed by Mr. Morris, NetCo would retain the entire local exchange network. Requiring the companies to separate the loop facilities from other local exchange facilities would require a level of detail and complication similar to that undertaken to implement the MFJ and would not be desirable, even if feasible. Separating the corporate functions is far easier than physically separating one piece of the LEC network from other pieces of that network.

network provider would offer nondiscriminatory pricing arrangements to retail competitors. We now examine each of the problem areas in light of these modifications to the LCI proposal.

The OSS Barrier: If the wholesale (facilities) operation of an RBOC were completely divested of the retail (customer) operation, the wholesale provider would have every incentive to provide a fully functional OSS capability to ensure that its network was being used. This would be analogous to the RBOCs' provision of equal access under the MFJ in the mid-1980's. The more traffic the RBOCs generated from different long distance providers, the greater its profit potential. Furthermore, up to a point, the RBOC would have incentives to deploy different types of OSS interfaces to accommodate different retail providers, depending upon the costs of deploying each interface. (Here we assume that ServeCo does not use its existing OSS but must use the same OSS systems as other CLECs.)

The wholesale provider's incentives to provide the type of interconnection sought by the retail provider is strongly affected by whether the wholesale provider profits from additional use of its network. Regulation that limits the carrier's profit potential might reduce the carrier's incentives to cooperate with the retail providers. But since most states and the FCC have given the RBOCs substantial flexibility to increase their profits through price cap regulation, the NetCo would appear to have sufficient regulatory incentives to satisfy the OSS and UNE Platform demands of several retail competitors. If the wholesale provider's profits increase with network usage, it is more likely to provide the OSS systems and the UNE platforms in a manner that suits multiple retail providers. On the other hand, inattentive regulation could allow the wholesale provider to charge excessive rates that reduce demand while maximizing profits. Again, regulators should be able to address these issues in a satisfactory manner.

The UNE Barrier: Under LCI's proposal, NetCo would continue to have incentives not to provide the UNE platform to competitors who compete with ServeCo's retail services. If NetCo is separated completely from ServeCo, however, NetCo would appear to have improved incentives to provide access to its network in whatever manner the retail provider would like, unbundled or bundled together in a platform. NetCo would not be in the business of providing retail services (except for those "legacy" consumers it continues to serve during the transition), so it would not have to worry about platform users taking its business away.

This analysis is somewhat dependent on pricing. If the prices for the platform are reasonably related to the prices it is allowed to charge for the individual UNEs, then NetCo's incentives to provide the platform would appear to equal its incentives to provide individual UNEs. Although setting the prices of individual UNEs in sync with platform prices may be difficult, regulators and market forces (i.e. arbitrage) should be able to establish rough parity between these sets of prices.

The Pricing Barrier: As with OSS, HoldCo would continue to prefer to give its retail subsidiary favorable pricing treatment as long as HoldCo owns both NetCo and ServeCo. If either NetCo or ServeCo is divested, however, this incentive to discriminate disappears. NetCo will continue to seek higher, non-cost-based prices for use of its network, under either LCI's approach or with complete separation of ownership. Only effective competition from facilities-based providers will constrain NetCo's pricing incentives. Until that time, NetCo's incentives to raise prices must be handled by regulators.

In sum, divesting ownership as well as operations of NetCo and ServeCo completely will improve significantly upon LCI's proposal by giving the network provider the maximum

incentives to provide nondiscriminatory OSS, provide the UNE platform, and assess prices in a nondiscriminatory manner.

D. Consistency with Section 271

LCI proposes that any RBOC that agrees to its restructuring plan be given a “rebuttable presumption” that it meets all three of the conditions for relief under Section 271. LCI proposes that the RBOC shall be presumed to meet the checklist, the separate affiliate requirements of section 272, and the public interest test. LCI suggests that compliance with the structural separation it proposes will allow the RBOC “fast-track” entry into the interLATA market.

It is not clear that this approach is advisable from either a legal or a public policy viewpoint. Section 271 of the Communications Act states that “The Commission shall not approve the authorization . . . unless it finds that” the three conditions are met. As the FCC has stated, this language clearly places the burden of proof on the RBOC to demonstrate that it has complied with the terms of section 271.⁵ Thus, the Commission does not have the authority to alter the burden of proof for satisfying the requirements of section 271.

From a policy perspective, LCI’s proposal would also appear to weaken the incentives of

⁵ The FCC stated in its Ameritech Decision:
Section 271 places on the applicant the burden of proving that all of the requirements for authorization to provide in-region, interLATA services are satisfied. . . . Because Congress required the Commission affirmatively to find that a BOC application has satisfied the statutory criteria, the ultimate burden of proof with respect to factual issues remains at all times with the BOC, even if no party opposes the BOC’s application.
In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services in Michigan, Memorandum Opinion and Order, CC Docket No. 97-137, August 19, 1997, Para 43. See also, para 105 (“In particular, we find that Ameritech has not met its burden of showing that it is providing access to operations support systems functions, interconnection, and access to 911 and E911 services, in accordance with the requirements of section 271(c)(2)(B).”)

the RBOC to “fully implement” the competitive checklist and comply with the other requirements of section 271. An RBOC that agrees to restructure itself in the manner suggested by LCI obtains the possibility of “fast-track” entry into the interLATA market. LCI’s Proposal would put the burden on competitors to show that the RBOC has not opened its network and complied with the other preconditions to interLATA entry. LCI appears to believe that NetCo’s marketplace incentives to increase traffic on its network from all competitors will be a stronger incentive to open its network to competitors than the incentives to enter into the interLATA market as set forth in the legislation. This is an interesting assumption that deserves greater scrutiny. The checklist, however, is the essential prerequisite to competition, and the FCC needs to investigate LCI’s theory fully before altering its section 271 strategy in such a fundamental manner.

While LCI’s proposal may not comport with the language and the theory of Section 271, there are two other ways that LCI’s approach could be considered. First, the FCC could consider the RBOCs’ action to separate its wholesale and retail arms under the public interest test. The public interest approach gives the FCC greater flexibility than the checklist to accommodate different proposals and ideas. The FCC could consider whether the RBOC has separated its wholesale and retail arms as one factor that informs its consideration of whether the public interest test is met.⁶

⁶ CPI has elsewhere proposed, and continues to believe, that the most important factor in evaluating the public interest test is to determine whether consumers in the relevant state have a realistic choice of an alternative local exchange carrier. CPI also recognizes, however, that the public interest standard allows the FCC great discretion and that the FCC should consider many factors in its public interest analysis. A restructuring of an RBOC, as proposed in these comments, could be considered as one of the additional factors that the FCC

A second approach is to consider a version of LCI's proposal independently of Section 271. Rochester Telephone Company (now Frontier) and Southern New England Telephone have offered to restructure themselves even though they are not bound by the interLATA ban. Rather than tying these restructuring proposals to relief under Section 271, the Commission should consider tying potential restructuring proposals to the possible deregulation of an RBOC's retail services. LCI itself suggests that the ServeCo would be deemed a non-dominant carrier to the same extent as a CLEC that is not affiliated with an RBOC. CPI is concerned that giving this relief automatically to the ServeCo may be premature. It would be more reasonable for the Commission to consider deregulating the retail carrier after analyzing the restructuring and the market in which ServeCo operates. The Commission must also consider the jurisdictional consequences and limit its regulatory relief to the interstate services that ServeCo offers. Nevertheless, it may be that the prospect for deregulation of the retail arm would be enough of an incentive for an RBOC to restructure itself without violating or affecting the process under Section 271.

Conclusion

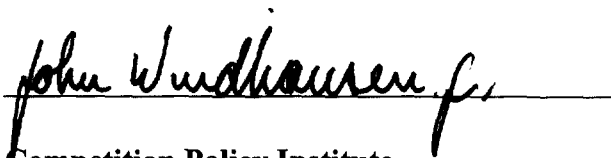
LCI has offered a thoughtful and creative approach toward the future regulation of the RBOCs. LCI has identified a number of problems with the current pace of local telephone competition and suggests that getting at the root of the problem (the RBOCs' incentives) may be more fruitful than a detailed regulatory approach. Unfortunately, LCI's proposal does not solve all the problems it has identified. If the wholesale and retail providers remain under common

should consider under the public interest prong.

ownership, the incentives to delay retail competition will be lessened but will not be eliminated.

The Commission should consider requiring the network and retail operators to be separately owned and separately operated in order to satisfy the objectives of opening the local network to multiple retail competitors. Failing a complete divestiture, the Commission could consider applying the safeguards proposed by LCI (40% outside ownership, compensation tied to performance, etc.) to the network owner, rather than to the retail subsidiary. The Commission should also consider approaches that will not run afoul of the provisions of Section 271 of the Telecommunications Act.

Respectfully Submitted,

A handwritten signature in dark ink, appearing to read "John Windhausen, Jr.", is written over a horizontal line.

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Certificate of Service

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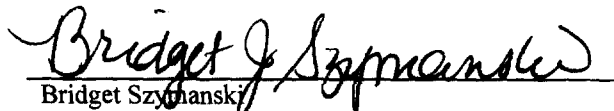
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